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POISON PILLS AND LITIGATION UNCERTAINTY

CHARLES M. YABLON*

Five or six years ago, as hostile takeovers became an increasingly common and accepted part of American business practice, the general belief was that incumbent management could take no action that would effectively prevent a hostile takeover. Available defensive tactics were a mixed blessing. "Shark-repellent" charter amendments,¹ for example, might increase a raider's costs and potentially delay the acquisition of control, but such amendments also signaled management's perception of its company as a target that a persistent raider could capture.²

Litigation against a hostile offeror was also primarily a delaying tactic.³ An offeror could always deflect claims based on inadequate disclosures by making additional disclosures. Only on rare occasions did successful litigation of antitrust or certain other specialized claims actually lead a court to require that a raider abandon its bid. Such claims, which could shut down an offer completely, were known as "show-stoppers."⁴

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1. Such amendments are intended to make target companies less attractive takeover candidates and to protect minority shareholders in case tender offers succeed. The various kinds of shark repellents are discussed in Friedenberg, *Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32, 35-48 (1982).

2. As a noted expert on tender offer defenses wrote at the time: "[t]he efficacy of these provisions has been subject to debate, and considerable skepticism expressed. The skepticism is warranted if a company adopts a shark repellent and believes itself then immune from a takeover." 1 A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING* 11 (1983) (footnote omitted); see also E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* 259 (1973) (describing restrictions on voting as "classic examples of overreaction to the tender offer phenomenon"); Fogg, Foye & Sunberg, *Developments and Trends in Non-Negotiated Acquisitions and Takeovers*, in *ACQUISITIONS AND MERGERS: TACTICS AND TECHNIQUES* 93, 144 (Practising Law Inst. 1983) ("While a supermajority provision may give shareholders protection in a partial tender offer, it has little effect on an acquiror who seeks control through a stock accumulation program to be followed by a proxy contest or through . . . any and all tender offers.").

3. See Merrifield, *Defensive Tactics*, in *CASH TENDER OFFERS* 155, 165 (Practising Law Inst. 1974).

4. If the target's primary objective is to remain independent, litigation may provide the avenue to success. But success usually requires a "show-stopper," i.e., a substantive violation by the bidder which results in an injunction against the offer and which cannot be readily cured. For example, the target may claim that the bidder is violating the margin rules or regulatory change-of-control requirements which are applicable to the target [sic].

The appearance, in 1983 and 1984,⁵ of the ominously named "poison pill" shook this view of the dynamics of takeover contests. For the first time, there arose a corporate show-stopper—a device that incumbent management could adopt by itself and that would have effects on a hostile raider so drastic and expensive that no offer could be consummated without target management's approval. When litigants first tested the legality of the pill before the Delaware Supreme Court in *Moran v. Household International, Inc.*,⁶ those opposing the poison pills, including the SEC, argued that the pill, if declared legal, would "virtually eliminate hostile tender offers."⁷ Other experts in the field predicted that no one would ever make a hostile offer in the face of a poison pill defense.⁸

It hasn't quite worked out that way. The Delaware Supreme Court in *Moran* did hold that management's adoption of the pill in that case was legally permissible,⁹ and poison pills have since become part of many companies' takeover defenses.¹⁰ Yet, raiders continue to successfully make hostile tender offers for control of such companies. Most of these raiders have succeeded not by obtaining legal invalidation of pills (although that has occurred in some cases)¹¹ and not by following offering strategies that avoid triggering the dilutive effects of pills (such strategies have worked in the past, but more sophisticated pill drafting has

In some cases, litigation has been used as part of an overall "scorched earth" strategy of some targets to stymie and demoralize a bidder.

1 A. FLEISCHER, *supra* note 2, at 299-300; *see also* E. ARANOW & H. EINHORN, *supra* note 2, at 266 ("Where appropriate, legal action may be the surest method of bringing the offer to a grinding halt and . . . may often be enough to assure the ultimate defeat of the offer.").

5. The poison pill's forerunners, dividends of preferred stock with very favorable conversion features, emerged in 1983. Marty Lipton has said that he conceived of the poison pill in December, 1982. OFFICE OF THE CHIEF ECONOMIST, SEC, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 1 n.1 (1986). Companies adopted the first pills with "flip-over" provisions in 1984. *See* CORPORATE ANTI-TAKEOVER DEFENSES: THE POISON PILL DEVICE xviii, Intro.-1 (P. Richter ed. 1988) (introduction by H. Bloomenthal) [hereinafter CORPORATE ANTI-TAKEOVER DEFENSES].

6. 500 A.2d 1346 (Del. 1985).

7. A. FLEISCHER, G. HAZARD & M. KLIPPER, BOARD GAMES: THE CHANGING SHAPE OF CORPORATE POWER 84 (1988) (quoting SEC's amicus brief in *Moran*).

8. *Id.* (describing testimony of Richard C. Abbott, former head of mergers and acquisitions at Morgan Stanley & Co., and Alan Greenberg, Chief Executive Officer of Bear Stearns & Co.).

9. *Moran*, 500 A.2d at 1357.

10. In the aftermath of *Moran*, over 300 companies adopted poison pill plans. Helman & Junewicz, *A Fresh Look at Poison Pills*, 42 BUS. LAW. 771, 771 (1987). By mid-1988, over 500 corporations had adopted them. A. FLEISCHER, G. HAZARD & M. KLIPPER, *supra* note 7, at 86.

11. *See, e.g.*, Bank of N.Y. Co. v. Irving Bank Corp., 139 Misc. 2d 665, 670-71, 528 N.Y.S.2d 482, 485-86 (Sup. Ct.) (target enjoined from enforcing rights plan that limited authority of any board other than present board to redeem), *aff'd*, 143 A.D.2d 1074, 533 N.Y.S.2d 167 (1988).

limited their success).¹² Rather, these raiders have succeeded because incumbent managers have eventually proved willing to redeem pills as part of negotiated resolutions of takeover contests.¹³

The question, of course, is why such settlements occur. If the pill is indeed such an effective deterrent, then why don't incumbent managers, secure in the knowledge that no raider in its right mind would attempt a takeover in the face of such a defense (no offeror has ever taken an action that has triggered a pill's dilutive provisions), simply hunker down, declare offers "inadequate," and tell raiders to get lost? Conversely, if, as some of the most recent cases indicate,¹⁴ the poison pill serves primarily as a delaying tactic and may not be used to indefinitely prevent shareholders from obtaining and evaluating tender offers, then why are offerors willing to raise their offer prices substantially in exchange for management redemption of pills?

The answer to these questions requires an appreciation of the legal uncertainty that surrounds the use of poison pills. Almost every raider, as one of its first acts after announcing a tender offer, brings suit against the target and its board of directors, seeking either invalidation of the pill or an order requiring the board to redeem it.¹⁵ Thus, at the time when incumbent management makes its decisions regarding redemption and settlement, it is also actively defending a lawsuit. This litigation involves substantial legal uncertainty. Many states have now made a threshold

12. The most successful example of such a strategy was pursued by Sir James Goldsmith's takeover of Crown Zellerbach. By acquiring over 50% of Crown Zellerbach's shares, but not proposing any second-step transaction, Goldsmith avoided triggering the flip-over provisions of the company's pill. Tharp, *Goldsmith Wins Fight for Crown Zellerbach Corp.*, Wall St. J., July 26, 1985, at 3, col. 1, 12, col. 1. Such a strategy would not have worked, however, if the Crown Zellerbach pill had had a flip-in as well as a flip-over provision. See *infra* text accompanying notes 26-27.

13. See Comment & Jarrell, *Two-Tier and Negotiated Tender Offers: The Imprisonment of the Free Riding Shareholder*, 19 J. FIN. ECON. 283, 296-97 (1987). As Comment and Jarrell's study of cash tender offers between 1981 and 1984 indicates, 45% of the offers that began as non-negotiated (i.e. not involving a written agreement approved by management) had been negotiated (i.e. settled) by the offer's consummation date. Another 31% were successfully consummated without settlement, and 24% were not consummated. *Id.* Although the study does not say so, at least some of the offers that were not consummated probably also involved settlements, that is, agreements by the raider to withdraw in exchange for greenmail, standstill agreements, seats on the board, or other consideration.

Unfortunately, the time period covered by the study overlaps with the early introduction of the poison pill; as a result, the study does not fully indicate the poison pills' effect, which was probably to increase the occurrence both of negotiated takeovers and of defeated takeovers (which may also involve negotiated settlements). Recent takeovers that have occurred after negotiated settlements, without any judicial invalidation of a target's pill, have occurred in such hotly contested matters as Campeau's takeover of Federated Department Stores, BNS's takeover of Koppers Co., and Philip Morris' acquisition of Kraft.

14. See *infra* notes 54, 80-87, and accompanying text.

15. In virtually every case, moreover, the raider conditions consummation of its offer on such judicial invalidation or board redemption. See *infra* note 46.

determination whether their corporate laws permit the adoption of poison pills.¹⁶ However, a raider or target director who wants to know whether and under what circumstances target management can permit the triggering of a validly adopted poison pill, and when management has an affirmative fiduciary obligation to redeem the pill, will find that the answers remain uncertain.¹⁷

This uncertainty about the circumstances in which management can actually use poison pills accounts, I believe, for much of the pressure that drives raiders and incumbent management to the bargaining table. If this is true, then litigation uncertainty is an important and functional aspect of the law regulating poison pills. Yet most analyses either ignore litigation uncertainty or, if they notice it at all, assume that such uncertainty itself poses a "problem." Some seek to "solve" this problem by trying to discern clear operational rules behind the unclear and sometimes conflicting language of judicial opinions.¹⁸ Others seek to eliminate it by prescribing in clear and certain terms what they believe are the most appropriate rules for courts to follow in the future.¹⁹ In either case, litigation uncertainty is viewed as both temporary and troubling, a gap in the law that must be filled.²⁰

This Article takes a contrary perspective. It considers the uncertainty surrounding the permissible use of poison pills as a significant part of the legal climate in which takeover contests occur. The Article analyzes the causes of this uncertainty and its effects on the participants in a takeover contest. Part I shows that under a regime of legal uncertainty, both raiders and incumbent boards face constraints and incentives substantially different from those presented by a law that clearly prohibits or clearly permits the use of poison pills. Part II then argues that the cur-

16. See *infra* notes 57-58.

17. Indeed, the *Moran* court, in approving Household's adoption of a poison pill plan, stated that it was expressing no opinion about whether management could actually allow the pill's dilutive effects to be triggered. *Moran*, 500 A.2d at 1357; see *infra* notes 61-65 and accompanying text.

18. Practicing lawyers tend to follow this approach. See, e.g., CORPORATE ANTI-TAKEOVER DEFENSES, *supra* note 5, at Intro.-52 to -54 (offering "guides to corporate counsel"); Helman & Junewicz, *supra* note 10, at 774-88 (drawing specific "procedural and substantive standards" from recent decisions). As an indication of the degree of uncertainty that marks this area, some have described the effort to eliminate the uncertainty as impossible. Dawson, Pence & Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 423, 438 (1987) ("The implications and ramifications of the litigation involving poison pills are uncertain. Nor can it be predicted with any degree of certainty which direction the courts will take in the inevitable future litigation.").

19. Academic lawyers tend to favor this approach. See, e.g., Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 270-72 (1989).

20. For example, Gilson and Kraakman argue that unless the Delaware courts articulate a new standard, the uncertainty regarding poison pills will collapse into "yet another rhetorical embellishment of the business judgment rule." *Id.* at 260.

rent level of litigation uncertainty is not a temporary aberration, but rather the most likely outcome of judges' and corporate lawyers' rational behavior. Litigation uncertainty is therefore likely to diminish slowly, if at all. Finally, part III considers the normative question of what the legal rules governing poison pills should be. It concludes that, under certain fairly plausible assumptions, the case for continuing legal uncertainty may be stronger than the case for a rule that clearly permits the use of poison pills or a law that clearly prohibits such use.

I. THE EFFECTS OF LEGAL UNCERTAINTY IN POISON PILL LITIGATION

A. *Poison Pills: The State of the Art*

The term "poison pill" has no precise definition. It generically denotes a range of defensive techniques,²¹ usually adopted by boards of directors as amendments to company bylaws. Such amendments generally authorize creation of a new class of securities, and "Rights" to purchase those securities. The board then makes these Rights available to stockholders by declaring a dividend of one Right per outstanding common share.²² At the time when the board declares the "dividend," the Rights have neither economic significance nor, for that matter, any physical existence.²³

21. The Chief Economist's report refers to poison pills as a "family of shareholder rights agreements." OFFICE OF THE CHIEF ECONOMIST, SEC, *supra* note 5, at 1. In this Article, I do not propose to discuss all of the various kinds of devices that have at one time or another been labeled "poison pills." See *infra* note 24 for a brief mention of some of these devices. Rather, for expository purposes, I consider a "typical" pill, one that combines both flip-over and flip-in provisions and gives a board wide-ranging power to redeem the pill or suspend its operation.

22. The powers and provisions relating to the Rights are usually set forth in considerable detail in a Rights Agreement, which is generally publicly disclosed through filings with the SEC.

23. The present "right" conferred by a Right usually has no economic value. For instance, the Right may permit its holder to purchase a "unit" (one one-hundredth of a share) of a new issue of preferred stock, whose dividend is so low that no one would purchase it at the exercise price. However, just in case some Rights holder were, for some bizarre reason, to decide to exercise the Right, the agreement governing the Rights generally provides that such Rights cannot be exercised until the so-called "Distribution Date." Finally, as a further demonstration of their insubstantiality, the Rights have no physical existence when declared. Rather, they are usually "attached implicitly" to the target's outstanding common stock certificates; they trade along with that stock. Rights holders do not receive certificates evidencing the Rights until the "Distribution Date," which is triggered by events that portend a change in control, such as an announcement that a person has obtained beneficial ownership of twenty percent or more of the target's common stock, or any person's announcement of an intention to commence a tender offer that, if successful, would give that person beneficial ownership of thirty percent or more of the target's stock.

In theory, such a distribution enables the stock and Rights to trade separately. In actuality, however, most pills give management the power to delay distribution of the Rights certificates even if the Distribution Date has occurred. Actual distribution of rights certificates has rarely occurred.

These Rights do, however, contain provisions that become important in the event of a hostile takeover attempt. Most common are "flip-over" provisions, which provide that when a raider successfully obtains more than a specified percentage of a target's shares, all Right holders will, if a subsequent merger or other combination or transaction between target and raider takes place, have the right to purchase a specified amount of the raider's stock for half its market value. Also common are "flip-in" provisions, which operate like flip-overs except that they give each Rights holder the right to purchase for the purchase price of the Right, an amount of the target company's own common stock worth twice the purchase price of the Right. For example, a flip-in, once triggered, might give each Right holder the right to buy \$500 worth of target shares for \$250.²⁴

24. The term "poison pill" also applies to securities and rights with different sorts of provisions, including "back-end" provisions, which give each target shareholder except the raider a right to sell her stock to the target company at a premium price. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), involved the effects of a poison pill with such a provision. Most agree that if the rights available under discriminatory back-end provisions ever became exercisable, they would violate the SEC's all-holders rule, 17 C.F.R. § 240.14d-10 (1988). See, e.g., CORPORATE ANTI-TAKEOVER DEFENSES, *supra* note 5, at Intro.-45. Other pill variations include voting provisions that give shareholders other than a raider enhanced voting rights, and provisions that, by giving shareholders power to redeem a pill by a supermajority vote, mimic the effect of various state antitakeover statutes. This type of provision has become increasingly popular since the Supreme Court's decision in *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987) (upholding Indiana antitakeover statute that allows acquirers of control shares to vote acquired shares only if majority of disinterested shareholders grant them voting rights). See, e.g., *MCA Inc. & Chase Manhattan Bank, Rights Agreement* (July 15, 1987), reprinted in CORPORATE ANTI-TAKEOVER DEFENSES, *supra* note 5, at 2-110 to -175.

Many of these pill provisions have economic effects that resemble the effects of other defensive tactics not generally considered to be poison pills. For example, a back-end provision giving every shareholder except a raider the right to sell a portion of her stock to the company at a premium price functions like a defensive stock-repurchase program, and can be analyzed accordingly. A lively debate in the law reviews addresses the subject of defensive stock repurchases. See, e.g., Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377, 1383 (1986) (defensive stock repurchases unfairly pressure target shareholders to sell and give target managers too great a competitive advantage; they should not be allowed except in the form of self-tenders that seek at least the number of shares sought by outside bidder and do not prevent outside bidder from tendering its holdings to target); Gordon & Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295, 297 (1986) (examination of academic models used in Macey and McChesney's and Bradley and Rosenzweig's articles reveals unwarranted assumptions that render authors' conclusions invalid); Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985) (greenmail sometimes improves tender offer prices and efficiently compensates those who supply information on stock values). Likewise, some of the recent work on dual-class common stock can contribute to analysis of provisions that enhance certain shareholders' voting rights. See, e.g., Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119 (1987) (analyzing difficulty of transferring control under dual-class stock structure and effects of transfer on economic incentives and shareholder wealth); Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1 (1988) (dual-class recapitalizations may decrease shareholder wealth and create "the fact or appearance of a self-perpetuating managerial elite"). Finally, pill provisions that create incentives and constraints similar to

The real reason why Rights exist is to prevent the occurrence of a "triggering event," an event that activates flip-over or flip-in provisions. Flip-over provisions are generally triggered by events that diminish or destroy the economic value of a target's common stock (such as an acquirer's proposal of a merger in which the target stock will be canceled).²⁵ In such circumstances, the Right "flips over" and becomes a right to purchase the acquirer's common stock at a bargain price. The flip-over thus poses a powerful deterrent to any raider who seeks to acquire majority control through a tender offer and then to remove minority shareholders through a back-end merger. It does nothing, however, to deter a raider who is content to acquire control of a company without effecting a back-end merger. For that reason, many recent pills contain flip-in as well as flip-over provisions. A host of events, including, in many cases, the mere acquisition of more than fifty percent of a target's stock, can trigger a flip-in.²⁶

Flip-ins generally provide that once a raider (or a raider's affiliate) acquires any Right, that Right becomes void and may not be exercised. Thus, a flip-in, when triggered, gives every Right holder except the raider a virtually irresistible bargain (the right to buy target stock at half the

those created by state takeover statutes can be analyzed like such statutes—also the subject of a vast literature. See, e.g., Coffee, *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups*, 1988 WIS. L. REV. 435 (1988) (state antitakeover statutes may legitimately protect target shareholders and managers); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 189 (1987) (analyzing effects of state "fair price" statutes).

25. In one recent pill, three occurrences could trigger such a flip-over: (a) a merger or consolidation in which the target is not the surviving entity; (b) a merger or consolidation in which the target is the surviving entity but all or part of the target's common stock is exchanged for another party's stock or for cash; or (c) sale of over 50% of the target's assets to another party. Federated Dep't Stores, Inc. & Manufacturers Hanover Trust Co., Rights Agreement § 13(a) (Jan. 23, 1986) [hereinafter *Federated Pill*].

26. For example, the Federated pill provided for triggering of the flip-in any time an "Acquiring Person" (a person who beneficially owns 20% or more of the target stock), *id.* § 1(a), engages in any of a number of transactions with the target, including (a) a merger in which the target company is the surviving entity with its common stock unchanged, (b) transfers of assets from the Acquiring Person to the target in exchange for the target's common stock, (c) sales or pledges of target company assets on terms and conditions less favorable than those obtainable through "arm's-length negotiation," (d) any transaction at all between the target and the Acquiring Person involving assets of \$10,000,000 or more, (e) any compensation paid to the Acquiring Person by the target (other than for full-time employment at regular rates), and (f) any loans, guarantees, tax credits, or other financial assistance from the target to the Acquiring Person. *Id.* § 11(a)(ii)(A).

The pill also triggers the flip-in whenever any person becomes beneficial owner of over 50% of the target's common stock by any means except a tender offer for all shares, approved by a majority of the board and the target's shareholders, *id.* § 11(a)(ii)(B), and whenever any transaction involving the target that would have the effect of increasing the proportionate holding of an Acquiring Person by 1% or more, takes place *id.* § 11(a)(ii)(C).

market price).²⁷ Once exercised, these rights put substantially more stock in the Right holders' hands, diluting the raider's holdings.

The current generation of pills gives incumbent management substantial power and discretion to delay or eliminate a poison pill's deleterious effects on offerors. Many pills authorize incumbent directors to suspend the exercise of Rights for a substantial period of time following a triggering event, and almost every pill now provides that a majority of incumbent directors can cause the target corporation to redeem the Rights for a nominal price, thereby removing their deterrent effect on offerors.²⁸

In sum, poison pills serve two fundamental objectives: (1) they provide maximum deterrence to hostile offers by severely limiting the actions that raiders can take without triggering a pill's flip-in or flip-over provisions, and (2) they give incumbent board members maximum flexibility to remove a pill's deterrent effects, if and when they decide to do so.

27. Since no flip-in or flip-over provisions have ever been triggered, the precise mechanics of their operation remain unclear. Apparently, however, such provisions would give all Rights holders except the Acquiring Person a pro rata right to purchase a fixed amount of stock, an amount set by the average market price of the relevant stock during some period prior to the triggering event. Thus, in the Federated pill, if an acquirer became beneficial owner of over 50% of target stock by May 9, 1988, and the average price of target stock over the thirty-day period prior to that time was, for example, \$50, then each Right would in effect become an option to buy 10 shares of the target for \$250. See *id.* § 7. The Chief Economist's report makes just this assumption concerning the mechanics of flip-overs, see OFFICE OF THE CHIEF ECONOMIST, SEC, *supra* note 5, at 10-11, as do the models developed in this Article.

28. Rights plans generally specify a period during which the Rights can be redeemed. Under the Federated pill, for example, they can be redeemed at the board's option at any time up to ten days after a person acquires 20% of the target, and the board can even extend the redemption period beyond that date by majority vote. Federated Pill, *supra* note 25, § 23(a). In order to ensure that an acquirer cannot easily dismantle these provisions by electing a majority of directors to the board or removing the incumbents, some Rights plans, including Federated's, use the concept of a "Continuing Director." These are defined as any director, not affiliated or associated with an Acquiring Person, who either sat on the board as of the date of the Rights plan or was subsequently elected to the board by a majority of the Continuing Directors. *Id.* § 1(g). Only a majority of Continuing Directors can approve a tender offer or exchange offer; this restriction prevents an offer's consummation from triggering the flip-in provisions. *Id.* § 11(a)(ii)(B). Such a provision theoretically enables management to suspend a pill's provisions for one offer (the approved one) and keep them in place for any competing offers.

A New York court, however, has held the use of such "Continuing Director" provisions invalid under New York law. See *Bank of N.Y. Co. v. Irving Bank Corp.*, 139 Misc. 2d 665, 670-71, 528 N.Y.S.2d 482, 485-86 (Sup. Ct.), *aff'd*, 143 A.D.2d 1074, 533 N.Y.S.2d 167 (1988). In *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 441-42 (S.D.N.Y. 1988), a federal district court considered but refused to rule on the legality of such provisions.

B. *The Problem of Distorted Choice*

This section examines the poison pill's effect on both offerors and target shareholders. As the section will show, the use of a poison pill creates a distorted-choice problem that is almost a mirror image of the distorted-choice problem presented by tender offers in the absence of any defensive tactics. A tender offer for an "unprotected" target has a good chance of success even if a majority of target shareholders believe that the value of the consideration offered by the raider is below their estimate of the value of their shares absent such a transaction. Conversely, a tender offer for a target effectively protected by a poison pill is likely to fail even if a majority of target shareholders believe the value of the transaction offered by the raider is above their valuation of their shares absent such a transaction.

The "distorted-choice" effect on unprotected targets has been most fully developed in the legal literature by Lucian Bebchuk.²⁹ The effect arises, to some degree, in every offer in which the value available to tendering shareholders exceeds the value later available to non-tendering shareholders.³⁰ For example, a perceived disparity will arise if a raider launches a partial offer and gives target shareholders reason to believe that after acquiring control, it will depress the value of remaining shares before proposing a second-step freeze-out transaction. The raider can publicly announce such a disparity in value by making a front-end-loaded, two-tier offer that expressly provides greater value for tendered shares than for shares taken up in the second step.

As an illustration, assume that you are a shareholder of Sitting Duck Co., a quiet little company with no tender offer defenses. Assume further that the company's 10,000 shares are publicly traded and that no one owns more than 1%. Although the stock has recently been selling at around \$80 per share, you believe the company has a bright future and subjectively value your shares at approximately \$100. Moreover (as a simplifying assumption), you know that other Sitting Duck shareholders place the same value on their shares.

Opening the paper, you discover that Coercive Co. has announced a tender offer for Sitting Duck. Coercive is offering to pay \$100 cash per

29. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1717-33 (1985).

30. Bebchuk points out that even a cash offer for 100% of a target's shares that is followed by a second-step merger at the same price involves some disparity in value between the two steps; since the money available in the second step has a lower time value. *Id.* at 1710. However, when the second step follows reasonably quickly after the first, this disparity is relatively slight. The remainder of this Article will treat offers for "any and all" target shares as nondistorting (and hence noncoercive).

share for up to 6000 shares (or 60%) of Sitting Duck stock. Coercive also announces its intention to follow the acquisition with a second-step merger in which it will exchange the remaining 40% of Sitting Duck shares for debt securities worth \$85 per share.

Given the fact that you value Sitting Duck stock at \$100 per share, this offer does not strike you as a particularly good deal. You believe that the 10,000 outstanding shares of Sitting Duck are worth at least \$1,000,000 in the aggregate, yet Coercive is offering the Sitting Duck shareholders only \$940,000 in aggregate value ($(6000 \times \$100) + (4000 \times \$85)$). Since every other Sitting Duck shareholder agrees with your valuation, if the shareholders were to vote or otherwise collectively decide whether to accept Coercive's offer, they would reject the deal.

But shareholders do not decide as a group and usually cannot coordinate their responses to an offer. When faced with the *individual* decision whether to tender your shares to Coercive, you confront a different set of incentives. If you tender and the offer succeeds, you will receive a blended value of at least \$94 per share.³¹ If you do not tender and the offer succeeds, you receive only the payment that Coercive offers in the second-step merger, \$85 per share. Furthermore, if you tender and the offer does not succeed, you get your stock back and stand in the same position as if you had never tendered at all. Thus, absent any ability to coordinate with other shareholders, you are best advised to grit your teeth and tender your shares, even though the amount you expect to receive falls short of the value you place on your stock.³²

The problem of distorted choice also appears in situations in which poison pills are legal and management has no obligation to redeem a pill or to prevent it from being triggered.³³ To illustrate the problem in this context, assume that you hold stock in another company, Porcupine Co., which exists under such a legal regime and has a poison pill that contains flip-over and flip-in provisions with a \$250 exercise price.³⁴ Porcupine also has 10,000 shares outstanding and no large shareholders, and you and all other shareholders value the stock at \$100 per share.

31. The \$94 figure assumes a tender of 100% of the shares and proration of the available value. In fact, since some shareholders always fail to tender, probably slightly more than 60% of the tendered shares will be taken up at the front-end price.

32. Bradley, Desai & Kim, *Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3, 16 (1988).

33. For a description of this coercive effect on shareholder choice, see OFFICE OF THE CHIEF ECONOMIST, SEC, *supra* note 5, at 10-12. Professor Michael Jensen apparently first discussed the effect in his testimony as an expert in *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985). See OFFICE OF THE CHIEF ECONOMIST, SEC, *supra* note 5, at 12.

34. See *supra* notes 21-28 and accompanying text.

Clearly, Coercive's bidding strategy for Sitting Duck would not work in a bid for Porcupine. In the first place, the strategy would involve considerably more expense when applied to Porcupine. In addition to offering \$100 per share for the 60% taken in the first step and \$85 per share for the remaining 40%, Coercive would trigger the flip-over rights of the 40% minority, which would require payment of \$1,000,000 ($4000 \times \250) over and above the \$940,000 that Coercive expects to pay for Porcupine's common stock. Coercive attempts to solve this problem by abandoning its two-step strategy, tendering for *all* of Porcupine's shares, and requiring, as a condition of its offer, that at least 90% of the outstanding shares (along with their accompanying Rights) be tendered.³⁵ In doing so, Coercive is offering a deal with an aggregate value of \$1,235,000 ($(9000 \times \$100) + (1000 \times \$85) + (1000 \times \$250)$), considerably more than the amount at which Porcupine shareholders value their stock. If the shareholders could coordinate their responses, their most rational strategy would be to tender the 90% on a pro rata basis, thus giving each share a blended value of \$123.50.

Without such coordination, however, shareholders' individual decisions result in a distorted choice that is the mirror image of the non-poison-pill scenario. In this case, if you tender and the offer succeeds, you receive \$100 per share. But if you do not tender and the offer succeeds, you receive \$355 per share (\$85 for the share and \$250 from the flip-over Right). If the offer does not succeed, it makes no difference whether you tendered or not. Accordingly, in this scenario, you reluctantly refrain from tendering, and the offer fails, even though it exceeds your and the other shareholders' valuation of Porcupine's shares.

One important factor, however, distinguishes the two scenarios. In the poison pill scenario, Porcupine's board has the power to solve the shareholder-coordination problem by offering to redeem the pill in a negotiated transaction in which Coercive pays \$123.50 for each share. Presumably, Coercive would have no objection to such a deal, since it has already offered to pay the same aggregate value for the Porcupine shares. The question, of course, is whether Porcupine's directors would have any incentive to make such a deal.³⁶

Certainly, standard corporate law doctrines give directors a fiduciary duty to act in what they believe are the best interests of shareholders.

35. The Delaware Supreme Court in *Moran*, 500 A.2d at 1354, suggested this approach as one of the strategies for defeating poison pills.

36. Incentives play a crucial role. In a non-poison-pill scenario, an offeror has the power to remove most of the distorted-choice effects simply by changing the terms of its offer to provide equal value to target shareholders in the first and second steps. This power is quite useless, however, since an offeror has no incentive to structure its offer in a way that makes it less likely to succeed.

ers,³⁷ and some analyses of takeover defenses assume that target directors' actions will generally accord with target shareholders' best interests.³⁸ However, the extensive economic literature on agency costs,³⁹ as well as a healthy skepticism about the propensity for self-sacrifice by human beings in general and by corporate managers in particular, may lead one to the opposite conclusion: in a legal regime like the one postulated in the second (Coercive/Porcupine) model, where poison pills are legal and management has no obligation to redeem or prevent their exercise, management might well refuse to redeem a pill voluntarily even if the aggregate value offered by a raider exceeded the value of those shares to the target shareholders.⁴⁰ Working from this conclusion, the remainder of this Article will presume that managerial action results primarily from incentives and constraints on managers, and not from a desire to maximize value for shareholders. In the second model, where the legal regime gives managers no personal incentives to redeem pills and imposes no constraints on their failure to do so, this presumption implies that often no redemption will occur and the offer will fail.

C. *The Effect of Legal Uncertainty*

The effects seen in the first two models do not apply only to the polar cases, legal regimes that either proscribe all poison pills or impose no constraints on their use. The same effects will appear in any legal regime that *clearly* establishes, prior to litigation in any particular case, when management may allow the exercise of poison pills and when management must redeem them. Under any legal rule that clearly specifies which situations fall into each of these groups, all participants in a takeover know whether they are functioning in circumstances that permit the use of poison pills. Raiders know whether they can obtain an injunction against a pill's exercise; directors know whether they have an obligation to redeem a pill. In any such situation, either the incentives and effects

37. See, e.g., N.Y. BUS. CORP. LAW § 717(a) (McKinney Supp. 1989); *Cheff v. Mathes*, 41 Del. Ch. 494, 506, 199 A.2d 548, 555, (1964) (directors discharge duty by showing good faith and reasonable investigation).

38. See, e.g., Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104 (1979) (corporate management serves shareholders' long-term interests).

39. See, e.g., Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 179-82 (1985) (under liberal corporate governance structures, managers will not always act in shareholders' best interests, since monitoring and bonding costs are high); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976) (agent's decisions and decisions that would maximize wealth of principal diverge even at optimal levels of monitoring and bonding).

40. This point does not necessarily imply that, by doing so, management breaches a fiduciary duty to shareholders. Management may not know at what price target shareholders value their shares; even if management knows, it may think the shareholders' valuation erroneous.

described in the first model apply, or the incentives and effects described in the second model apply. The only situations that might imply a different result fall under a third model, in which the participants are *uncertain* about which legal regime governs their behavior.

In this model, assume that everything is as in the second model, except that there is a 50% probability that if Porcupine Co.'s management fails to redeem the pill prior to the occurrence of a triggering event, a court will hold that it has breached its fiduciary duty. Of course, there is also a 50% probability that the court will hold management's failure to prevent the triggering of the pill perfectly legal.

Coercive, recognizing this 50% probability that it will be operating under the same legal regime as in the first model (no poison pills), makes the same offer it made in the first model: \$100 cash for the first 60% and \$85 in value for the second-step merger. Recognizing, however, the potentially disastrous consequences of that offer under a legal regime such as the one in the second model (poison pills allowed), Coercive conditions its offer on either the Porcupine board's redemption of the pill or a preliminary injunction against the pill's use.⁴¹

Coercive has structured its tender offer to maximize benefits and minimize losses, given legal uncertainty. If the outcome favors Coercive (a non-poison-pill result), Coercive will obtain a benefit, V , equal to the value that it would gain by obtaining 100% of the target.⁴² Presumably, Coercive has sought to maximize V by, among other things, pricing its offer at the lowest level it believes would succeed under a non-poison-pill

41. Such conditional offers for companies protected by poison pills have become common. See, e.g., *In re Damon Corp. Stockholders Litig.* (Nomad Acquisition Corp. v. Damon Corp.), [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040, at 90,870 (Del. Ch. Sept. 16, 1988) (offer conditioned on redemption of Rights plan).

42. Strictly speaking, the value of V is the difference between the profit Coercive expects to recognize on its acquisition of the target (i.e., the value of the target to Coercive minus its acquisition cost, including associated transaction costs) and the next most profitable use of the funds with which Coercive is making the acquisition. If we indulge the standard assumption that Coercive acts in an economically rational manner, then Coercive must believe that purchasing target shares is the best—i.e., most profitable—use of the available funds. Accordingly, if as a result of the operation of the poison pill Coercive cannot make that investment, it will be forced to employ its funds in a way that it, by definition, finds less desirable (presumably because less profitable).

The opportunity to purchase target shares has a positive value of V for Coercive, and the loss of that opportunity represents a detriment, or cost, of an equivalent amount. While the company could not recognize such a loss on its books, nor deduct such a loss on its income tax returns, a rational, profit-maximizing firm nevertheless has an incentive to avoid such a loss. The loss, therefore, is nonetheless "real" in an economic sense. See generally P. SAMUELSON & W. NORDHAUS, *ECONOMICS* 469-72 (12th ed. 1985) (opportunity costs are real economic costs). My argument requires only a recognition that companies making tender offers have an incentive to maximize V and to avoid the loss of V that would result from an unsuccessful offer.

regime.⁴³ If the legal outcome is unfavorable (exercise of the pill is permitted), Coercive will simply withdraw its offer. While Coercive will find this result preferable to incurring the very high costs that triggering the flip-in or flip-over provisions of the pill would bring about, the result carries costs of its own. Withdrawing the offer means a loss of the benefit that Coercive hoped to obtain through a successful deal—that is, a loss of V . In addition, even if it withdraws the offer, Coercive will lose certain sunk costs, call them S , including commitment fees, legal and printing fees, and the time that Coercive executives spent preparing the offer.

If we look at a regime of legal uncertainty from Coercive's standpoint, then, it presents a risk, with an upside potential of a gain of V , and a downside risk of a loss of $V+S$. In short, given any positive value for S , that is, any offer that involves some sunk costs, an offeror's loss from losing a poison pill suit always exceeds the benefit of winning one.⁴⁴

Consider the same situation from the standpoint of Porcupine's managers, who operate under the same degree of uncertainty, albeit with a different definition of which result is favorable and which is unfavorable. In a favorable scenario for them, they are permitted to exercise the pill if they choose, Coercive withdraws its offer, and the Porcupine managers preserve the status quo, i.e., they maintain their control and the benefits that accrue to them by virtue of that control. Define C as the value that management puts on maintaining control.

An unfavorable result for management, on the other hand, can take one of three forms, depending on the timing of the judicial decision that proscribes the managers' failure to redeem the pill. In the event of motion for a preliminary injunction, such a ruling would occur prior to consummation of Coercive's offer. In that event, the offer would succeed, and the cost to management would be no more than C , and possibly some lesser amount if, as often occurs, stock options or golden parachutes mitigate the loss of C . If, however, no ruling occurs until *after* management's failure to redeem the pill has forced Coercive to withdraw its offer, a subsequent lawsuit, probably by target shareholders,

43. Since it has conditioned its offer on the redemption or invalidation of the pill, Coercive can price its offer as if the poison pill were not a factor.

44. This does not mean, of course, that an offeror will always seek to avoid such a suit. If an offeror has a sufficiently optimistic view of its chances of succeeding in such a suit, it might still consider the suit worth pursuing. For example, if the offeror stands to win only \$100 from a successful suit, and lose \$200 from an unsuccessful one, it should still bring the suit if the chances of success are greater than or equal to 75%. See *infra* note 50.

Moreover, in an auction contest, the losing bidder's loss of $V+S$ may be lessened or even offset by the profit that the bidder makes by tendering previously purchased target shares into the higher offer. In a single-bidder situation, in contrast, an offeror stopped by a poison pill will probably experience a loss on previously purchased target stock, the value of which is likely to drop once the offeror abandons the offer.

would carry a much larger potential cost to the managers: the shareholder group's loss of the premium offered in the deal. Call this value from the loss of the deal D . An even more disastrous scenario for management would be to permit the triggering of the flip-in or flip-over provisions, dilute the raider, and then lose a suit by the raider for the damages caused by that dilution. Call this value, the cost of illegally triggering the flip-in or flip-over provisions, F .⁴⁵

This model helps to explain why parties have strong incentives to obtain some judicial resolution of the redemption issue prior to an offer's consummation or abandonment. From the perspective of a raider, who will only consummate the merger if a court orders redemption or invalidates the pill, the incentive is obvious. Either an unfavorable judicial resolution or a failure to obtain such resolution results in the same loss to the raider, $V+S$. The model also indicates why target management might want to obtain such a resolution prior to an offer's consummation or abandonment.⁴⁶ Assuming that D or F , management's potential loss from a raider's lawsuit after an offer is withdrawn or a pill triggered, exceeds C (or the fraction of C that management will actually lose if the offer is consummated), then management has an interest in seeking judicial resolution prior to the consummation or withdrawal of the tender offer, since that is when it faces the lowest potential loss from an unfavorable result.

An interesting asymmetry exists, however, in the possible results of such judicial resolution, which is most likely to follow a raider's motion for a preliminary injunction requiring management to redeem a poison pill. A preliminary injunction will, of course, take away management's discretion whether or not to redeem the pill. But a denial of such an injunction will neither prohibit management from redeeming the pill nor ensure the legality of a subsequent failure to redeem. This continuing

45. It seems extremely unlikely that any offeror would actually sustain a loss of F , since such a loss could arise only from purchases of shares while an unredeemed pill remained outstanding, something an offeror would almost never do. The only scenario I can envision in which such an event *might* occur involves litigation uncertainty. Most raiders condition tender offers on obtaining preliminary injunctive relief invalidating a pill or ordering its redemption. If a trial court ordered such invalidation or redemption, an offeror, relying on that order, might subsequently purchase target shares. If the trial court's order were reversed on appeal, the pill arguably could come back into effect, with its flip-in or flip-over provisions already triggered. Admittedly, even this scenario assumes a somewhat irrational (or at least unsophisticated) offeror. In the Grand Metropolitan-Pillsbury takeover, in contrast, even after Grand Met had obtained judicial invalidation of Pillsbury's poison pill, it did not actually purchase shares until it and Pillsbury's management reached a subsequent agreement (which presumably included dismissal of any pending appeals). Gibson & Smith, *Pillsbury Agrees to \$5.75 Billion Offer by Grand Met After Poison Pill Is Struck down in Delaware Court*, Wall St. J., Dec. 19, 1988, at A3, col. 1.

46. This would not be true when management seeks limited delay in order to develop a superior offer.

uncertainty follows from the nature of preliminary injunction rulings, which have no claim-preclusive or issue-preclusive effect.⁴⁷ More importantly, courts commonly decide such motions on grounds such as lack of irreparable injury, which provide little or no guidance on how the court might ultimately rule on the substantive issue of redemption.⁴⁸

These considerations help to explain why so many poison pill cases settle before a court has finally determined whether target management has satisfied its fiduciary duty with respect to redemption.⁴⁹ Assume that a court either has not yet decided a raider's motion seeking redemption of a pill or has decided the motion on grounds that do not determine management's fiduciary duty with respect to redemption. Assume too that each side perceives a 50% probability of a result adverse to it. The raider, facing a 50% chance of a gain of V and a 50% chance of a loss of $V+S$, sees a greater potential for downside loss than for upside gain if the case proceeds to final resolution. Similarly, management, assuming that its potential liability for damages in the amount of D or F exceeds the value of C , also faces a greater downside loss than upside gain if the matter proceeds to final resolution. In such a scenario, both sides have an incentive to eliminate the possibility of downside loss by settling the case.⁵⁰

In short, as long as there exists a substantial possibility that management can legally trigger a pill, raiders have a strong incentive to remove

47. Both issue and claim preclusion require a final judgment on the merits. See RESTATEMENT (SECOND) OF JUDGMENTS §§ 13, 27 (1982). Moreover, the results of a preliminary injunction motion do not bind a court in subsequent proceedings in the same case.

48. Indeed, because the issue of whether a court should force target management to redeem a pill arises while management still has the *option* to redeem the pill, a court can easily decline to decide the issue, either for lack of ripeness or lack of irreparable injury. See, e.g., *Doskocil Cos. v. Griggy*, No. 10,095, slip op. at 7 (Del. Ch. Aug. 18, 1988) (Westlaw, 1988 WL 85491) (issue not ripe because target company's directors "have not yet decided to take any action" to activate pill); *Facet Enters. v. Prospect Group, Inc.*, No. 9746, slip op. at 6 (Del. Ch. Apr. 15, 1988) (Westlaw, 1988 WL 36140) (denying preliminary injunction prohibiting enforcement of Rights; auction would soon take place).

49. Even in the case of court-ordered redemption, both sides have incentives to settle in order to avoid further litigation, including the possibility of reversal on appeal, see *supra* note 45, and the desire to make a relatively orderly transition of control. Of course, since the trial court's order in such a case dramatically alters the relative probabilities of outcome, one would expect such a settlement to involve a relatively small increase in the price offered to target shareholders.

50. The situation resembles a two-player game in which each player stands an equal chance of winning \$100 or losing \$200. A risk-neutral person should not only refuse to play such a game, but should be willing to pay \$50 to avoid playing. One can compute the certainty equivalent for a risk-neutral person as follows:

Probability	Outcome (return)	Value
.50	\$100	\$50
.50	(\$200)	(\$100)
1.00		(\$50)

that possibility through negotiation, and as long as there is a substantial possibility that, in failing to redeem the pill, management may be found to have breached its fiduciary duties, management has a strong incentive to remove that possibility through negotiation. When both parties have strong incentives to remove litigation uncertainty, the likely result is a negotiated settlement.⁵¹

Incumbent management can also seek to remove the danger of a downside loss in another way, by developing a competing, higher offer. The use of a poison pill as a "gavel" to run an auction, largely by giving targets far more than the twenty business days specified by the Williams Act⁵² to develop competing bids, is becoming well-established.⁵³ Here again, a significant degree of uncertainty about the appropriate use of poison pills seems to facilitate the auction process.

If there were a definite time period after which a raider could purchase shares without worrying about dilution by a poison pill, then an inadequate offer would always have a chance of succeeding because extraneous factors delayed a potentially higher offer. Indeed, the amount of time needed for developing competing offers may vary considerably, depending on the nature of the company and transaction involved. Un-

Of course, a risk-averse player would be willing to pay even more to get out of the game. See generally W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE* 208-16 (3d ed. 1988), from which this chart is adapted.

This model suggests that a party will have an incentive to settle whenever the product of the probability and the magnitude of the downside outcome exceeds the product of the probability and the magnitude of the upside outcome. The model is consistent with much of the literature on settlement, which acknowledges the role of pessimism in inducing settlements. See, e.g., Posner, *The Summary Jury Trial and Other Methods of Alternative Dispute Resolution: Some Cautionary Observations*, 53 U. CHI. L. REV. 366, 370 (1986) (introducing mathematical model for settlement process, in which "if both parties are pessimistic . . . the case will be settled"); Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 13 (1984) (same). The model departs from that literature, however, and agrees with Professor Schuck in positing that when both sides face substantial downside outcomes, an increase in uncertainty can create incentives to settle. See Schuck, *The Role of Judges in Settling Complex Cases: The Agent Orange Example*, 53 U. CHI. L. REV. 337, 353 (1986) (in *Agent Orange* case, Judge Weinstein induced settlement by separately explaining each side's case's weaknesses to that side).

51. The presence of an incentive to achieve a negotiated settlement does not mean that settlement will actually occur. Strategic behavior, miscalculation, and just plain orneriness lead parties to fail to settle even when both sides have incentives to do so.

52. 15 U.S.C. § 78n(e) (1982); 17 C.F.R. § 240.14e-1(a) (1988).

53. Authority for this use of poison pills apparently first derived from language in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986), an opinion that praised the use of a back-end pill for "spurr[ing] the bidding to new heights." The appropriations of such a use of a poison pill was moot, however, by the time that case was decided: the board had agreed to redeem the pill as part of a negotiated transaction. *Id.* Since that time, use of the pill to benefit an auction has also been approved in *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 440-43 (S.D.N.Y. 1988) and *Facet Enters. v. Prospect Group, Inc.*, No. 9746, slip op. at 6 (Del. Ch. Apr. 15, 1988) (Westlaw, 1988 WL 36140).

certainty concerning the amount of extra time created by the poison pill both limits the raider's ability to "grab" the company prematurely and creates an incentive for management to develop alternatives expeditiously and not to search indefinitely. As the Delaware Court of Chancery recently demonstrated in *Grand Metropolitan, Public Ltd. Co. v. Pillsbury Co.*, at some uncertain point, the extra time provided by the use of the pill can expire.⁵⁴

II. THE UNCERTAINTY OF POISON PILL LAW

This part considers the current degree of uncertainty in the law governing poison pills, particularly in Delaware law. It then considers the sources of that uncertainty and the forces tending toward greater or lesser certainty and predictability in poison pill litigation. The part concludes that while courts will undoubtedly decide many more poison pill cases in the future, the question in particular cases whether management can use poison pills or must redeem them will remain substantially uncertain.

One should note that the "substantial" uncertainty necessary to create an incentive to settle can be far less than the 50% level used in the preceding models.⁵⁵ Indeed, such a probability, implying pure randomness of result, is unlikely in most cases in a developed legal regime. Even a much lower level of uncertainty, however, can create powerful incentives to settle, given the very large costs likely to be incurred either by a raider who triggers and is diluted by a poison pill or by a board held to have illegally triggered such dilution.⁵⁶

Of course, a blanket prohibition of poison pills, adopted by statute or judicial decision, would eliminate any uncertainty about their use. A number of courts have in fact held that certain types of pill provisions, generally flip-ins that discriminate against offerors, violate state corporate law.⁵⁷ In those states, little uncertainty about the use of such poison pills remains. Courts or legislatures in other states, however, have recog-

54. See [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104, at 91,188, 91,190, 91,195 (Del. Ch. Dec. 16, 1988).

55. See *supra* note 50.

56. For example, a director who values her continuing position of control at \$100,000 has a strong incentive to settle a case in which her potential liability is \$1,000,000, even if the director believes there is only a 10% chance of losing the case.

57. *Spinner Corp. v. Princeville Dev. Corp.*, No. 86-0701, slip op. (D. Haw. Oct. 31, 1986) (enjoining flip-in and back-end provisions as unlawfully discriminatory under Colorado law); *Amalgamated Sugar Co. v. NL Indus.*, 644 F. Supp. 1229, 1234 (S.D.N.Y. 1986) (holding flip-in ultra vires under New Jersey law), *aff'd*, 825 F.2d 634 (2d Cir.), *cert. denied*, 108 S. Ct. 511 (1987); *Bank of N.Y. Co. v. Irving Bank Corp.*, 139 Misc. 2d 665, 670-71, 528 N.Y.S.2d 482, 485-86 (Sup. Ct.) (enjoining Rights plan with "Continuing Director" provision), *aff'd*, 143 A.D.2d 1074, 533 N.Y.S.2d 167 (1988).

nized that typical poison pill provisions do not violate corporate statutes.⁵⁸

The same asymmetry noted above in the preliminary injunction context⁵⁹ appears here as well. While a prohibition of poison pills implies certainty about the inappropriateness of their use, public-law acceptance of pills provides no concomitant certainty about when and how management may use them.⁶⁰

A. *The Current State of Delaware Law*

Current Delaware law aptly illustrates this uncertainty. In the leading Delaware case concerning poison pills, *Moran v. Household International, Inc.*, the Delaware Supreme Court held that Household's flip-over poison pill, which the company adopted prior to any hostile offer, was not a per se violation of Delaware law.⁶¹ The court went on to consider whether the board's decision to adopt the pill was a valid exercise of fiduciary duty. Finding that the board had decided based on adequate information and that its action was "reasonable in relation to the threat posed,"⁶² the court held that the board's action was protected by the business judgment rule.⁶³

The court warned, however, that neither its ruling on the formal legality of Household's pill nor its approval of the board's actions in adopting the pill provided any basis for concluding whether or under what circumstances the board could validly exercise the pill. As the court stated, "[t]he ultimate response to an actual takeover bid must be

58. See, e.g., WIS. STAT. ANN. § 180.155 (West Supp. 1988); *Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829, 847-49 (D. Minn. 1986) (in action to preliminarily enjoin target's pill, court, after finding lack of irreparable harm to plaintiff takeover group, nonetheless went on to consider likelihood of success on merits and held flip-in provisions not ultra vires under Minnesota law), *aff'd in part and vacated in part*, 811 F.2d 414, 420 (8th Cir. 1987) (vacating holding on flip-in provisions, since "[a]fter determining there was not irreparable harm . . . the district court was not required to go further"); *Dynamics Corp. of Am. v. CTS Corp.*, 637 F. Supp. 406, 409, 416 (N.D. Ill.) (finding poison pill not a per se violation of Indiana common law, although adoption constituted breach of fiduciary duty in that case), *aff'd*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985) (defendant corporation's flip-over pill did not by its terms violate Delaware law and adoption was legitimate exercise of business judgment); see also *Stricharchuk & Stewart, Goodyear Tire to Buy Interest from Sir James*, Wall St. J., Nov. 21, 1986, at 3, col. 1, col. 2 (discussing temporary Ohio statute validating poison pills, passed in connection with proposed takeover of Goodyear).

59. See *supra* notes 47-48 and accompanying text.

60. See *infra* notes 64-65 and accompanying text.

61. 500 A.2d at 1353.

62. *Id.* at 1356. The court was applying the "proportionality" test that it had enunciated in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

63. 500 A.2d at 1356-57.

judged by the Directors' actions at that time, and nothing we say here relieves them of their basic and fundamental duties to the corporation and its stockholders."⁶⁴

Thus, in light of *Moran*, Delaware courts view a board's decision not to redeem a pill as a defensive tactic separate from the board's decision to adopt the pill and apply separate proportionality review to this decision not to redeem.⁶⁵ This development initially led some to expect that the caselaw would soon generate specific rules defining and delineating the precise circumstances under which management has an obligation to redeem a poison pill,⁶⁶ and the specific circumstances under which it has no such obligation.

Although Delaware courts have now decided quite a few poison pill cases, no such clear and precise rules have emerged. Rather, Delaware seems to have purposely avoided clarifying the loose standard governing poison pill redemption (and defensive tactics generally), a standard that relies on such notoriously vague concepts as "reasonableness" and "proportionality."⁶⁷ That standard has permitted the Delaware courts to

64. *Id.* at 1357 (citing *Unocal*, 493 A.2d at 954-55, 958). The court also stated:

When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, . . . [t]hey will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the Rights Plan.

Id. at 1354 (again citing *Unocal*) (emphasis added).

65. The court's citations to *Unocal* indicate that the same "proportionality" test applies to the decision to redeem as applies to other defensive tactics. Subsequent Delaware cases have in fact applied the proportionality test to the redemption issue. See *infra* note 83 and accompanying text.

66. These commentators usually acknowledge the confusing or uncertain state of current law, while assuming that new cases will resolve that confusion eventually. See, e.g., Brodsky, *Poison Pills*, N.Y.L.J., Sept. 17, 1986, at 1, col. 1 (noting that current case-by-case approach "mak[es] predictability difficult" but that future cases will determine "[w]hether courts . . . refus[e] to apply the business judgment rule to takeover defenses," "adopt the [*Unocal*]" approach, "or . . . take some other approach"); see also Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73, 101-03 (1986) (noting that recent Delaware cases have generated "confusion," but that "the courts of Delaware (and other states) must continue to fashion the substance of fiduciary duty").

67. We can divide legal principles into two general categories. First are "rules," which limit factual inquiry in order to achieve certainty and predictability of result. For example, only two relatively uncontroversial facts are relevant to a determination of when a tender offer may be consummated: when the offer began and when 20 business days have expired. Second are "standards," which denote looser legal principles that permit consideration of more factors in the hope of obtaining a more individualized and equitable result. For example, Rule 10b-5's prohibition of all "fraudulent and deceptive" practices may not very clearly define the conduct being prohibited, but most believe that the Rule's vagueness itself aids the Rule's deterrent effect and effective enforcement. While these two categories are, of course, relative, Delaware's law governing defensive tactics seems to resemble a "standard" much more than a "rule." As the text illustrates, courts sometimes find vague standards more useful than precise rules. See generally Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976) (identifying two opposed modes for dealing with questions about the form that legal solutions should take: a formal mode that favors de-

engage in wide-ranging factual inquiries to test the "reasonableness" and "proportionality" of managers' conduct.⁶⁸ Wary of any attempt to legislate in this area, the Delaware courts do not even try to enunciate a more specific "test" or limit the factors relevant to the issue of poison pill redemption. Rather, each decision tends to provide a detailed factual description of the transaction at issue, followed by a determination that management's response does or does not meet the proportionality test.⁶⁹ Since every case involves a different transaction, case outcomes cannot logically conflict in such a situation.⁷⁰ Any attempt, however, to identify one or two dispositive factors in one case is rebuttable by another case in which the same factors were present and lacked dispositive effect.⁷¹

A loose legal standard like the proportionality test contributes to legal uncertainty in two ways. First, courts' identification of a panoply of relevant factors with no ranking among them makes predicting outcomes difficult, even as precedent develops.⁷² Moreover, a loose standard permits courts to look not just at the terms of a tender offer, but also at all the various participants in the takeover contest, their personalities, their

financed, general rules, and an equitable mode that produces ad hoc decisions with little precedential value).

68. Any "reasonableness" test, such as the *Unocal* proportionality test, tends to be highly context-specific and fact-sensitive. A defensive tactic that is reasonable with respect to one offer (for example, a two-tier offer with junk bonds on the back end and a relatively low premium) might well prove unreasonable with respect to an offer involving different terms or a different offeror. Delaware caselaw since *Unocal* tends to reflect this highly fact-specific approach.

69. *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227 (Del. Ch. 1988), provides a good illustration. In that case, which involved a motion for a preliminary injunction against a management restructuring by Macmillan, Inc., designed to defeat a takeover attempt by the Bass Group, Vice-Chancellor Jacobs spent nine and one-half pages discussing the background facts, one-half of a page describing the general legal standards involved, two pages discussing whether the Bass Group was a "threat," and five pages discussing whether the defensive restructuring was reasonable.

70. *In re Damon Corp. Stockholders Litig.* (Nomad Acquisition Corp. v. Damon Corp.), [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,040, at 90,868 (Del. Ch. Sept. 16, 1988), decided a few months after *Bass*, also involved a defensive restructuring. Although the restructurings in the two cases had many common characteristics, Vice-Chancellor Hartnett had no trouble distinguishing the case, "because in [*Bass*,] the record showed that the board acted with an entrenchment motive." *Id.* at 90,871.

71. *In Facet Enters. v. Prospect Group, Inc.*, No. 9746, slip op. at 6 (Del. Ch. Apr. 15, 1988) (Westlaw, 1988 WL 36140), Vice-Chancellor Jacobs noted precisely these aspects of current Delaware law:

The rapidly evolving law makes any precise legal formulation in this fast moving area a somewhat hazardous endeavor that is best left for another day. For purposes of this motion it is sufficient to note that in each of these cases the result was highly fact specific, and that none of those cases involved the exact circumstances presented here.

72. Consider a case for which two arguably relevant precedents exist. In case one, the court held that a transaction with characteristics *a*, *b*, and *c*, constituted a threat sufficient to justify management's refusal to redeem a poison pill. In case two, the court held that a transaction with characteristics *a*, *x*, and *y* did not pose such a threat. In such a situation, it is impossible to predict the outcome of a case involving a transaction with factors *a*, *b*, and *x*.

past actions, and their future policies for the target company.⁷³ Given this broad array of factors, each side in future cases will likely be able to come up with *some* particulars in which the offer at issue seems either less threatening than offers in cases enjoining the use of poison pills, or even more threatening than offers in other cases permitting the use of pills. As a result, each side will be able to make some fairly plausible arguments, arguments that will pose a substantial possibility of defeat for the other side.

A second source of uncertainty from a loose standard is the controvertibility of the facts themselves.⁷⁴ A standard like proportionality increases the quantity of potentially relevant facts about a transaction and the parties to it, making it more likely that at least *some* facts will become the subject of serious dispute. Furthermore, proportionality review permits inquiry into certain *kinds* of factual issues whose resolution is often unpredictable. Expert opinions concerning valuation, for example, are notoriously open to critique and rebuttal by equally persuasive experts. Determinations of motive and intent may also be crucial to a case's outcome, yet difficult to predict in advance.

Substantive legal standards aside, the procedural posture of most pill cases also creates litigation uncertainty. As part I demonstrates,⁷⁵ both sides in a poison pill case have incentives to seek adjudication of the redemption issue while the tender offer is pending. As a result, most pill cases involve preliminary injunction motions that seek redemption or invalidation of a pill before a takeover is completed. This procedural posture leads to very narrow, often entirely nonsubstantive rulings. Until recently, these rulings have generally fallen into two categories—those in which courts deny relief on purely procedural grounds, such as unripeness or lack of irreparable injury,⁷⁶ and those in which courts deny relief because they find management's failure to redeem pills reasonable in light of a promised or pending auction contest.⁷⁷ Even in these latter cases, however, courts limit their findings of reasonableness to the precise

73. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (corporate raider's "national reputation as a 'greenmailer'" was a relevant consideration).

74. See generally Frank, *What Courts Do in Fact*, 26 ILL. L. REV. 645, 649 (1932) ("The 'facts' of a 'contested' case, for judicial purposes, are not what actually happened between the parties but what the court thinks happened.").

75. See *supra* notes 41-46 and accompanying text.

76. See *supra* note 48 and accompanying text.

77. See, e.g., *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 441 (S.D.N.Y. 1988); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 476 (D. Del. 1988); *Tate & Lyle PLC v. Staley Continental, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,764, at 98,586 (Del. Ch. May 9, 1988).

time at which each motion is decided.⁷⁸ As part I likewise shows, in the face of such a nonresult, parties will most likely seek such a negotiated settlement.⁷⁹ Awareness of this pressure to settle may well contribute to courts' unwillingness to issue definitive rulings on poison pill issues.

In the fall of 1988, the Delaware Court of Chancery and Supreme Court decided a number of cases involving poison pills. In the *Macmillan*,⁸⁰ *Interco*,⁸¹ and *Pillsbury*⁸² decisions, Delaware courts for the first

78. For example, in *Federated*, 683 F. Supp. at 442-43, Judge Sand stated his concern that a definitive ruling would do more harm than good and thus limited his ruling not just to that case, but to that *point* in the proceedings. He warned the target's management that his refusal to grant the plaintiff an injunction at that point in the case did not mean that he would refuse to grant one later. See also *Koppers*, 683 F. Supp. at 474 ("board's responses *thus far* have been reasonable" (emphasis added)).

79. See *supra* notes 47-49 and accompanying text.

80. *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071, at 91,024 (Del. Ch. Oct. 17, 1988), *rev'd*, [Current Transfer Binder] *id.* ¶ 94,401, at 92,602 (Del. May 3, 1989). The case primarily involved the propriety of an auction contest conducted by a target that favored one of the competing offerors. Although the Delaware Supreme Court reversed the Chancery's determination that the deficiencies in the auction procedures were not sufficient to invalidate the auction, it did not disturb the "limited injunction" in which the Chancery Court ordered removal of the poison pill because once "the two highest bids [were] on the table," *id.* ¶ 94,071, at 91,024, the pill's purpose had been served. Indeed, that injunction had not been challenged by either party on appeal. See *Macmillan*, *id.* ¶ 94,401, at 92,595.

81. *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988). *Interco* involved a tender offer for Interco at \$74 per share. In response, the Interco board sought to implement a restructuring of the company, which it valued at "at least" \$76 per share. To prevent the consummation of the tender offer, and to ensure the success of its alternative restructuring, the board refused to redeem the outstanding poison pill. *Id.* at 793-94.

The chancery court, in requiring redemption of the pill, noted that the Interco was no longer using the pill to conduct an auction or otherwise seek to obtain a more valuable alternative to the tender offer. Such an alternative, the proposed restructuring, had already been obtained, and the pill at that point served only to prevent shareholders from selecting the other alternative, the proposed tender offer. The court held that the "threat" avoided by the pill, the possibility that shareholders would erroneously choose the less valuable alternative, did not justify use of the pill to deprive shareholders of the opportunity to make that choice. *Id.* at 798.

82. *Grand Metro., Pub. Ltd. Co. v. Pillsbury Co.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,104, at 91,188 (Del. Ch. Dec. 16, 1988). *Pillsbury* involved Grand Met's fully financed cash tender offer for all outstanding shares of Pillsbury; the offer commenced on October 4, 1988. *Id.* at 91,189. The \$63 offer price represented a 60% premium over the shares' prior market price. Grand Met conditioned its offer on redemption of Pillsbury's poison pill. *Id.* at 91,190.

In early November, as the period of the tender neared expiration, Grand Met sought a preliminary injunction ordering redemption of the pill. *Id.* When that motion was denied, Grand Met extended its offer but did not purchase any of the tendered shares, since such a purchase would have triggered the provisions of the (thus far unredeemed) poison pill. *Id.* at 91,193. Pillsbury, meanwhile, had announced a proposed restructuring that involved a spin-off of certain assets, notably its Burger King operations. Pillsbury's experts estimated that the restructuring promised shareholders at least \$68 in value per share, but that the value would not be realized until 1992 or 1993. *Id.* at 91,194. By the time Grand Met's preliminary injunction motion was again before the court on December 16, 1988, 87% of the outstanding Pillsbury shares had been tendered to Grand Met. *Id.*

In granting the injunction and ordering redemption of the pill, the court noted these factors: (1) the offer posed no "threat" to the corporate entity or any other constituency (indeed, the court

time granted preliminary injunctions invalidating or requiring redemption of poison pills. Yet these decisions, while they undoubtedly provide insight into the Delaware judiciary's views on these matters, have not made management decisions about poison pills any more certain.

None of these decisions announce any new legal rules. Rather, they all purport to apply the *Unocal* proportionality standard to facts that each case describes as unique and highly particularized.⁸³ Moreover, each of the cases turns on factual determinations, most importantly the "adequacy" of the prices offered,⁸⁴ that will raise uncertain and hotly litigated issues in any future takeover contest.

Nonetheless, these decisions do indeed change the law, by revealing new and important information about the attitudes of the Delaware courts. One would be mistaken, however, to assume that simply because the law has *changed*, it has necessarily become more certain. For example, the *Interco* case seems to create an operational rule that management may not use poison pills to protect its favored alternative in a contest where two adequate offers are available and shareholders might reasonably favor either one.⁸⁵ This is indeed new information, and in that sense a "clarification" of existing law, but the rule also mandates new inquiries regarding the "adequacy" and "reasonableness" of competing offers, thus engendering new uncertainty and contentious new factual issues.

The *Pillsbury* case also illustrates this phenomenon. It has been correctly described as refuting the so-called "just say no" defense—the view that management may always use a pill to prevent an offer that it deems inadequate.⁸⁶ The *Pillsbury* court found management's decision not to redeem the pill "unreasonable" on that case's facts, demonstrating that, at least in some circumstances, incumbent management cannot "just say no." Since we now know that management may not *always* use a pill to prevent the consummation of an offer that it deems inadequate, the ques-

stated that 50% of the shares in the Pillsbury employee pension plan had been tendered); (2) 87% of the Pillsbury shares had been tendered; (3) a reasonable shareholder could see it in her best interest to take \$63 then, rather than a potential \$68 in 1992 as a result of the proposed restructuring; (4) the real "threat posed" to shareholder value was a withdrawal of the Grand Met offer if the pill was left in place; and (5) in over two months, no competing higher offers for Pillsbury had emerged. *Id.* at 91,193.

83. *Pillsbury*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,192-93; *Interco*, 551 A.2d at 797-98; *Macmillan*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,021.

84. *Pillsbury*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,193; *Interco*, 551 A.2d at 797-98; *Macmillan*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,021.

85. See the discussion of *Interco*'s facts, *supra* note 81.

86. Gibson & Smith, *supra* note 45, at A3, cols. 3-4 (quoting a lawyer for Grand Met after the *Pillsbury* decision was announced as saying: "You remember [takeover lawyer Martin Lipton, an advocate of the poison pill defense] being quoted as saying you can just say no? Apparently, you can't." (quoting Allen Finkelson (insertion in original))).

tion becomes, when is such action permissible and when is it impermissible? While the *Pillsbury* decision may satisfy academic lawyers by resolving a preexisting legal debate, it is unlikely to make things any more certain for practitioners who must advise boards when they are now permitted to "say no."⁸⁷

B. *Pressures Toward Certainty*

Although the cases decided thus far have not increased the law's certainty or predictability, Delaware courts will certainly continue to decide poison pill cases; one could argue that as these cases get decided, the law surely must become more certain and predictable. Two basic arguments, one based on judicial action and the other on the responses of the corporate bar, support this position. The judicial action argument relies on the importance of precedent in any process of case-by-case adjudication. Fundamental ideas of fairness, in this view, require judges to take prior decisions into account in deciding the cases before them. To do so, they must interpret those prior decisions in a way that transforms them into the best and most coherent statements of the legal principles involved. According to this argument, then, by aiming at consistency, the process of adjudication always moves towards greater certainty, although it never attains absolute certainty.⁸⁸

This argument assumes that, to make sense of and consistently apply their prior decisions, judges must derive relevant principles from those decisions, thus moving the law toward greater abstraction and certainty. An alternative model of judicial behavior, however, emphasizes judicial discretion and flexibility aimed at reaching equitable results in individual cases.⁸⁹ As we have seen, the Delaware courts have tended

87. One can examine the factors that the court noted in granting the *Pillsbury* injunction, see *supra* note 82, and ask whether a variation in one or more of them would have affected the result. If the target board had reasonably feared changes in policy, would the court then have permitted a "just say no" defense? What if only a bare majority of shares, say, 52%, had tendered? What if the differential between the offer price and the board's restructuring had been higher? What if the court's estimate of the loss to shareholders had been lower? The *Pillsbury* case not only fails to answer these questions, but, by indicating the relevance of all these factors, it in effect raises such questions, arguably creating more uncertainty than would a rule that upheld all good faith determinations to "say no."

88. This view of the process of adjudication is probably most closely identified with Ronald Dworkin. See R. DWORKIN, *LAW'S EMPIRE* 225-75 (1986).

89. In this regard, it is worth noting that Delaware's trial court for corporate law matters is the Court of Chancery, in which almost every case involves a motion for injunctive relief. In such cases, the court can hardly avoid invoking equitable principles. Indeed, the Delaware courts have expressly referred to equitable principles in defending the lack of a clearer standard in poison pill cases. In *Tate & Lyle PLC v. Staley Continental, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,764, at 98,584 (Del. Ch. May 9, 1988), Vice-Chancellor Hartnett stated: "The Court of Chancery has historically been vested with considerable discretion and, although some might desire

toward this latter approach in ruling on issues of defensive tactics: by applying only a general standard of proportionality, the courts have left themselves discretion to decide each individual case on its facts. Under this model, additional caselaw may actually increase rather than decrease uncertainty.⁹⁰

The other argument for certainty and predictability focuses on the corporate bar itself. Surely corporate lawyers, given their need to advise clients, have an interest in achieving an understanding of the Delaware law that will enable them to predict results with relative certainty. Even if Delaware judges fail to derive general and predictable rules from their decisions, the corporate bar, through careful attention to the outcomes of such cases, might succeed in reinterpreting these cases to provide relatively clear and certain "working rules."

This function of the corporate bar is a dynamic force in the development of corporate law—a force that does seem to be operating in certain aspects of poison pill litigation. For example, a growing consensus among corporate lawyers holds that management, in order to give its shareholders a fair choice among competing alternatives, may use the threat of a poison pill to neutralize any timing or other procedural advantages that a raider may enjoy with respect to subsequently proposed transactions.⁹¹ Thus, a corporate lawyer advising an incumbent board would probably tell it that it has no obligation to redeem a pill while negotiating with a white knight or seeking an alternative, higher offer. Even this limited "safe harbor" of predictability, however, relies on an assumption (as yet untested) that if a raider actually sought to consummate an offer prior to the time when management had completed its negotiations with a white knight, management could validly dilute the raider by failing to redeem a poison pill. In other words, it is the threat that management will use the pill in a manner that is of *uncertain* legality (to actually dilute a raider) that makes the clearly permissible use (to run an auction) effective.⁹²

Moreover, while corporate lawyers do tend to seek "safe harbors," they also demonstrate a countervailing tendency to create "hard" cases. In an adversarial takeover situation, an action that constitutes a clearly permitted use of a pill for management constitutes a serious litigation problem for a raider. The raider might therefore try to change the situa-

a more definite standard, no hard and fast rule is likely or desirable which will apply to all factual circumstances."

90. See *supra* notes 72-74 and accompanying text.

91. See *supra* note 53.

92. The procedural status of most poison pill cases plays a part in the uncertainty here as well. For a discussion of this source of uncertainty, see *supra* notes 75-79 and accompanying text.

tion to provoke greater litigation uncertainty. It might, for example, offer to raise its price in exchange for the board's acquiescence in a merger proposal, thus complicating and unsettling management's claim that it needs the threat of the pill to buy time.⁹³ Such a tactic might force target management into a straight auction situation, in which it would have to offer to redeem the pill for the highest bidder. Alternatively, the tactic might cause the target to reject the offer outright, in which case target management would have to defend its nonredemption of the pill not as an attempt to force an auction, but on the much less certain ground that it wants to keep its company independent.

Another characteristic of corporate lawyers that increases legal uncertainty is their tendency to take whatever "worked" in a previous deal and push it a little bit further in the next one. Indeed, one can view the *Interco* and *Pillsbury* cases as attempts to do just that with the rule that management can use poison pills to run auction contests. In *Interco*, management used the pill not just to provide time for an alternative offer, but to decide the outcome of the contest.⁹⁴ In *Pillsbury*, after management had used the threat of the pill for a fairly long time to search out competing bids, the court said that continued use of the pill for this purpose, in the face of an "adequate" bid, was no longer reasonable in relation to the threat posed.⁹⁵ Given that the Delaware courts have held these uses too extreme and overreaching, we can expect the use of poison pills in the next auction cases⁹⁶ to be toned down just enough to create new "hard cases."⁹⁷ In short, the corporate bar acts as both a stabilizing

93. Philip Morris seems to have cut short Kraft's efforts to use the pill in order to buy time for a restructuring by offering an improved bid (although less than the amount Kraft had estimated as the value available in its restructuring). See Freedman & Gibson, *Kraft Accepts Philip Morris's Sweetened Offer Totaling \$3.1 Billion, or \$106 a Share in Cash*, Wall St. J., Oct. 31, 1986, at A3, col. 1.

94. See *supra* note 81.

95. See *supra* notes 86-87 and accompanying text.

96. Indeed, raiders need not wait until subsequent cases; they can change poison pills in mid-stream. For example, in *Henley Group, Inc. v. Santa Fe S. Pac. Corp.*, No. 9569, slip op. (Del. Ch. Mar. 11, 1988) (Westlaw, 1988 WL 23945), a shareholder seeking to wage a proxy contest challenged the 20% trigger on a flip-in provision as inhibiting his right to join with other shareholders to form a voting group of over 20%. *Id.* at 8. Management responded by amending the pill to create a "proxy carve-out" that would not trigger the pill and that, the court held, removed any threat of irreparable harm to the plaintiff. *Id.* at 10. Accordingly, the court denied the injunction, while leaving the pill in place and its overall legality adjudicated. *Id.* at 11.

97. If one could organize the terms of various poison pills (and various other defensive tactics) along a single continuum from "most" to "least" restrictive and rely on courts not to invalidate tactics that are "less" restrictive than other tactics that have previously been approved, then future adjudication would reduce predictive uncertainty by producing a clearer understanding of where "the line" is drawn. The process would be much like trying to guess somebody's age and being told "higher" or "lower" after each unsuccessful guess. Successive guesses would narrow the range of possibilities. Many envision legal decisionmaking in exactly this way. See, e.g., Dworkin, *Law as*

and destabilizing force in poison pill litigation;⁹⁸ whether its net influence tends toward greater certainty and predictability of result is far from clear.

None of these considerations, of course, means that developing clear and certain rules is *impossible*.⁹⁹ What the discussion does show, however, is that powerful structural forces in this area of the law tend to perpetuate a substantial degree of uncertainty and therefore prevent such clear and certain rules from arising.¹⁰⁰

Interpretation, 60 TEX. L. REV. 527 (1982). However, one can reasonably question whether the assumptions necessary to make this model viable actually apply to tender offer litigation (or, for that matter, to much other litigation).

For example, assume that two poison pill cases, *A* and *B*, have been decided, and that case *B* involves a more restrictive pill than does case *A*. A court has invalidated the pill in case *B* but has sustained the pill in case *A*. Based on this precedent, one should be able to accurately predict the result for any case involving a pill less restrictive than in case *A* or more restrictive than in *B*. The only area of uncertainty would be between *A* and *B*, and that uncertainty would decrease as the court decides more cases in that zone. However, if pill *A* were more restrictive than pill *B* with respect to certain factors but less restrictive with respect to others, then the precedents would not permit accurate prediction, except perhaps for pills identical to *A* or *B* (and knowledgeable parties would certainly do their best to avoid repeating the circumstances of case *A* or *B*). Additional cases under these circumstances might either increase or decrease certainty, since the pills in such cases would likely resemble valid pills in some respects and invalid pills in other respects.

Finally, neither courts nor lawyers have to account for every prior case. If case *A* or *B* is particularly inconvenient, a court can "limit it to its facts" or otherwise treat it as lacking rule-determining power. In short, if the law in this area is to become more certain, additional cases alone will not accomplish that result. Rather, as noted above, greater certainty will result from more clearly established common understandings among the corporate bar, the courts, and litigants—understandings that some legal actors will always have an interest in undermining.

98. This analysis suggests that corporate law may actually have an "equilibrium level" of uncertainty, at which the rules are clear enough to allow corporate lawyers to function effectively as expert predictors of legal outcomes, but sufficiently unclear to allow them to function effectively as inventors of new corporate devices and new hard cases. Whether such an equilibrium level exists and whether some aspects of corporate law have reached such an equilibrium are questions beyond the scope of this Article.

99. Such rules would most likely develop through the corporate bar's interpretation of an ambiguous case as a "leading case" containing a useful operational rule. Something like this seems to be occurring with *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), a "leading" but fairly ambiguous decision concerning the duty of care. After expressing considerable concern over what new duties of care, if any, that case imposes on directors considering merger proposals, the corporate bar seems now to be interpreting the case as merely imposing a formal requirement that boards conduct their meetings over extended periods of time, provide written information in advance, and conduct extensive discussion and questioning. Post-*Van Gorkom* cases indicate judicial acceptance of this interpretation. See, e.g., *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 575, 578 (11th Cir. 1988) (*Van Gorkom* duty of care requires use of studies to determine a fair price during merger deliberations, but does not necessarily require studies from independent sources); *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669, 676, 678 (Del. Ch. 1986) (*Van Gorkom* duty of care not satisfied when information regarding tender offer not given to shareholders sufficiently in advance of vote on recapitalization plan that was intended to thwart that offer).

100. One such force, discussed previously, is the procedural posture of most pill cases. See *supra* notes 75-79 and accompanying text. The "perfect" case, one in which a board's allegedly wrongful failure to redeem a pill has actually diluted a raider, is precisely the one least likely to arise. Such a

III. LEGAL UNCERTAINTY AS A REGULATIVE NORM

Scholars have extensively debated the normative question of which rules should govern the use of poison pills (and other defensive techniques),¹⁰¹ and I do not purport to resolve that question here. Rather, this part examines the *premises*, both normative and factual, that support various positions concerning the appropriate regulation of poison pill defenses. The part seeks to determine under what premises, if any, a regime of litigation uncertainty is preferable to more clearly defined rules governing the use of poison pills.

Any normative justification of poison pill regulation must answer three questions about the ends and means of takeover regulation. First, whom should the regulation seek to benefit? Second, what substantive rule would provide that group with the optimal benefit? Third, what institutional arrangement would in practice most nearly achieve that optimal result?

A. *The Goals of Takeover Regulation*

Regarding the first question, takeover regulation could seek to benefit three distinct groups: the shareholders of companies that are actually targets of hostile takeovers; the shareholders of all publicly traded companies, that is, companies that are actual or potential targets of hostile takeovers; and society at large.

The divergence of the first and second groups' interests raises an interesting policy question. The first group will benefit from any increase in a tender offer's price (that is, in the premium paid). Accordingly, to the extent that poison pills and other defensive tactics lead to auction contests and higher prices for target shareholders, they benefit this first group. From the perspective of the second group, the shareholders of *potential* targets, however, increases in the premiums paid in individual tender offers might produce a net detriment if those increases lead ulti-

case would involve enormous potential damages and would raise the fiduciary duty issue in a form that would make it hard for the courts to avoid squarely facing the issue. For a possible (albeit highly improbable) scenario in which such a case might arise, see *supra* note 45 and accompanying text.

101. Some of the most well-known articles are: Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341; Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229 (1986).

mately to a decrease in the total number of takeovers that succeed.¹⁰²

Commentators have generally assumed that maximizing the benefit to either one of these two groups results in a net gain to society; until recently, they have paid relatively little attention to the impact of takeovers on non-shareholder groups such as creditors and employees.¹⁰³ Indeed, the present structure of takeover regulation focuses on the interests of target shareholders, the group to whom corporate managers owe a fiduciary duty. If managers' defensive techniques in fact maximize shareholder returns, then present law is unlikely to condemn such action. Moreover, poison pill supporters generally defend pills on the ground that they enable directors to maximize benefits to target shareholders. The remainder of this discussion, then, will assume, as all of the caselaw and most of the theoretical discussions do, that takeover regulation exists to maximize benefit to target shareholders.

Having said that, one confronts the second question: what substantive rule maximizes these benefits? Here again, the literature suggests a number of different answers. If one assumes that a stock's pre-takeover market price best indicates its true value,¹⁰⁴ then takeover bids, since they always involve prices greater than the pre-takeover market prices, are always value-enhancing.¹⁰⁵ The optimal rule under these assumptions is one that permits the use of a poison pill as a "gavel" to run an auction and thereby obtain the highest price for shareholders, but never as a tactic to defeat an offer and permit a target company to stay

102. The debate on this issue has tended to focus on whether white knights and auction contests increase the costs incurred by those who first seek out takeover targets, thus decreasing their incentives to seek out and make initial tender offer bids. See Bebchuk, *supra* note 101, at 1034-38; Easterbrook & Fischel, *supra* note 101, at 1174-82; Gilson, *supra* note 101, at 824-31; Schwartz, *supra* note 101, at 242-44.

103. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 73-74 (1986) (in the past, shareholders have been seen as sole riskbearers and thus sole beneficiaries of directors' fiduciary obligations); Johnson, *Corporate Takeovers and Corporations: Who Are They For?*, 43 WASH. & LEE L. REV. 781, 784-87 (1986) (in the past, commentators have assumed that interests of shareholders and other societal groups coincide or that to extent that they diverge, public policy, not private management, should provide remedy); Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 173-74 (only recently have commentators begun to recognize the right of external actors, as well as shareholders and directors, to share in decisionmaking regarding corporate changes).

104. For a summary of the efficient-market hypothesis and analysis of its potential limitations, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 565-92 (1984); Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 344-77 (1986).

105. The sole exception would be an extremely coercive two-tier bid, with a second step way below market. In the current takeover market, however, it is hard to imagine such an offer ever being made, let alone succeeding.

independent.¹⁰⁶

Rather than relying on the valuation contained in the market price, however, one might assume, as the distorted-choice models presented in part I do,¹⁰⁷ that shareholders' subjective valuations of their stock may differ substantially from market price, and may be better indicators of value (or normatively preferable determinants of a takeover bid's success).¹⁰⁸ Under that assumption, the goal of takeover regulation would be to prevent the consummation of offers at prices below shareholders' subjective valuation of their shares. As we have seen, such undervalued offers may succeed if they take the form of "coercive" two-tier or partial offers under which target shareholders, to avoid a lower second-step offer or a minority position in a company controlled by the offeror, will tender their shares even if the tender price falls below their subjective valuation of their stock.

Courts or legislatures could give effect to the distorted-choice model's assumptions in tender offer regulation by simply prohibiting all two-tier and partial offers.¹⁰⁹ A blanket prohibition would force offerors to make "any and all" offers, which promise all shareholders the same aggregate value and allow shareholders to evaluate that figure without coercion.¹¹⁰ Offers that promise more than the subjective valuations of a sufficient number of shareholders would succeed, those that promise less

106. The first part of this rule seems to be becoming the law in Delaware. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), apparently gives incumbent management that has decided to endorse the sale of a company an affirmative duty to maintain an auction in which the highest bid will succeed. The use of a poison pill as a "gavel" in such an auction was expressly approved in *CRTC Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 439 (S.D.N.Y. 1988), and *Facet Enters. v. Prospect Group, Inc.*, No. 9746, slip op. at 6 (Del. Ch. Apr. 15, 1988) (Westlaw, 1988 WL 46064).

The second part of the rule, however, is not the law. As the previous part demonstrates, *see supra* notes 88-100 and accompanying text, it remains extremely unclear whether and when incumbent management may use a pill to keep a company independent (indeed, the effective use of the pill as a gavel for such an auction may well require such uncertainty).

107. *See supra* notes 29-40 and accompanying text.

108. One might believe that shareholders' subjective valuations of their stock are less reliable than market price, but that respect for private property normatively justifies a legal rule that protects shareholders from being coerced into giving up their property at a price that they subjectively think inadequate. *But see* Bebchuk, *supra* note 29, at 1764 & n.154 (refusing to embrace such an approach, and arguing instead that "[t]he undistorted choice objective is desirable for reasons of economic efficiency").

109. Note that even if we take account of the distorting effect of changes in the time value of money, *see supra* note 30, and drop the simplifying assumption of equal valuation by shareholders, *see* Bebchuk, *supra* note 29, at 1740-41; *supra* text following note 30, we can justify a blanket prohibition on partial and two-tier offers as a clear and certain rule that would eliminate the most coercive transactions.

110. The justification for a blanket prohibition on two-tier and partial offers rests on the assumption that no adequate offers will be deterred or diminished in value, since any such offer can be made as an "any and all" offer with the same consideration offered in the second step. If, however, some

would fail, and defensive tactics, including poison pills, would have no role except possibly to buy some time for an auction.

Thus, neither a market model nor a shareholder-choice model provides much justification for the use of poison pills, except in certain limited circumstances. This conclusion makes sense, since those models view either the market price or shareholders' valuations as the best determinants of an offer's adequacy. Poison pills, in contrast, take the ultimate decision about the adequacy of a tender offer away from market forces or the shareholder group, and give that decision to target management.¹¹¹ Accordingly, to justify the continued use of poison pills in tender offer contests, one must argue that, at least in some identifiable class of cases, incumbent management can better judge the adequacy of an offer than either the market or shareholders can.

Some have indeed argued that the market, and shareholders as a group, systematically "undervalue" the stock of certain companies. Target shareholders and the market are alleged to "discount" some corporations' assets below their true and realizable value, either because shareholders wrongly distrust management's plans to realize that value or because the market simply fails, for extended periods, to value certain types of corporate assets accurately. This view, long espoused by defenders of corporate management, who speak of the need for long-term investment strategies and the inappropriateness of pressuring managers to generate short-term profits, has been gaining increasing academic support.¹¹²

If one accepts the assumptions of this model, then at least in theory there are some offers that, while above current market price and shareholder valuations, are nonetheless inadequate in that they fall below the true and obtainable value of the corporation's assets. This model, unlike the other two, implies that management may appropriately use defensive tactics, including poison pills, not simply to buy time for higher bids, but also to prevent consummation of bids that seek to purchase undervalued corporate assets at a price below their true value. Of course, it may be impossible to develop an effective method for identifying such inadequate offers, but that raises a question of means, not ends.¹¹³

significant number of potentially adequate but coercively structured offers could not be restructured in this way, then something other than a blanket prohibition would be the optimal rule.

111. See *supra* note 28 and accompanying text.

112. See, e.g., Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 897-901 (1988) (attributing asset discounts to fear of future misinvestment by corporate managers and "mispricing" by uninformed traders).

113. Before we deal with the question of means, however, we should consider the extent to which empirical evidence can shed light on these policy issues. The primary empirical evidence on the effect of poison pills appears in a 1986 study by the Chief Economist of the SEC, which analyzes

B. *The Means of Poison Pill Regulation*

The assumption that market price provides the best indicator of value implies, as the rule for maximizing shareholder welfare, that man-

how the adoption of poison pills affected 245 corporations that adopted poison pills between June 1983 and July 1986. OFFICE OF THE CHIEF ECONOMIST, SEC, *supra* note 5, at 7, 22-23. The study makes two significant findings. First, it concludes that although for the sample as a whole the adoption of poison pills had no statistically significant immediate effect on stock prices, when the study limited the total sample of companies to those about which there was "takeover speculation" prior to the announcement of the adoption of a pill, the adoption of a pill led to a statistically significant diminution in average stock price of 1.7%. *Id.* at 42. Adoption of pills defined in the study as "discriminatory," primarily flip-in and back-end pills, had a more deleterious effect on stock prices, 2.2%, in situations involving takeover speculation. *Id.*

Second, the study found that of the 30 companies with pills that became subjects of control contests, 16 companies were acquired and 14 remained independent. Of the 16 acquired companies, 13 were acquired after auction contests which resulted in an average premium gain of 14%. The other three were acquired through creeping tender offers. In the six months following the defeat of the offers for the stock of the other 14 companies, the adjusted average price of these companies' stock declined 17%. *Id.* at 41 & tbls. 2-4. This figure led the study to conclude that "[t]hese empirical tests, taken together, show that poison pills are harmful to target shareholders, on net." *Id.* at 43.

The study provides important data on the effectiveness and utilization of poison pills during the relevant period. It shows that pills can indeed be show-stoppers, and were in about 46% of the cases. This level of failure of offers may seem high, particularly given the pressure toward settlement described in this Article. Yet if one compares it with Comment & Jarrell's study of offers between 1981 and 1984, Comment & Jarrell, *supra* note 13, at 296, which found that 24% of initial non-negotiated offers were unsuccessful, then the use of poison pills may account for a 22% increase in the rate of failure of hostile offers. Although Comment and Jarrell's study covers the period when the pill was first introduced, the success rates it reports for 1981 and 1982, when the pill was clearly not a factor, are consistent with the overall failure rate of about 25% for non-negotiated initial bids.

The fact that the introduction of poison pills may have caused the failure rate for hostile bids to rise from 24% to 46% does not refute the assertion that pills are not insurmountable obstacles. Even the SEC's data show hostile offers succeeding more often than failing. Moreover, while most "successful" takeovers undoubtedly involved negotiated settlements, some of the "unsuccessful" ones probably ended through negotiated buy-backs or other forms of "greenmail." This, too, comports with the model described above.

Finally, the time period of the SEC study, from mid-1983 to mid-1986, represents an early stage in the use of the poison pill, a time when the pill was perhaps viewed as a more formidable obstacle; the study may thus no longer reflect the impact of pills on the present takeover market. As the study also shows, incumbent management used the pill more often against "any and all" offers than against two-tier or partial bids. OFFICE OF THE CHIEF ECONOMIST, SEC, *supra* note 5, at 41-42. This statistic merely reflects that most of the offers studied were "any and all" offers. In order to reach its normative conclusions, however, the study must presuppose the answers to some of the questions discussed above.

The SEC study's methodology assumes that defensive maneuvers exist to benefit target shareholders. The study reaches its normative conclusion by weighing the benefits and detriments of poison pills from the target shareholder perspective. The study's methodology also presupposes that the appropriate measure of that benefit or detriment is the rise or decline of the market price of target stock in the wake of the adoption of a pill. Similarly, it assumes that market prices represent the best indicator of the actual value of corporate shares. As we have seen, however, those who argue for a greater management role in the use of poison pills challenge precisely that assumption. From this critical perspective, the study's results remain consistent with the view that the market generally undervalues some corporate shares. If the 14 companies that used the pill to defeat offers

agers should use pills only to foster auction contests, that is, to buy enough time to seek out the best offers available. Under such a rule, uncertainty may still play a useful role in regard to the timing of such contests. The use of pills has already made the Williams Act's twenty-business-day rule largely irrelevant to the determination of when a tender offer may be consummated.¹¹⁴ That decision now often lies in the hands of a Delaware judge, who can either end the waiting period by granting an injunction against a poison pill or extend the period by refusing to grant such an injunction. The argument for uncertainty and flexibility here is that giving management a flexible time period for developing competing offers, a period that can only be "closed" by a successful motion to force redemption of a pill, would permit individualized consideration of each auction process and would keep appropriate pressure on management to act expeditiously.

Moreover, where timing is in dispute, motion practice before a judge may prove more effective than other means of resolving the issue. The

were those whose shares the market "undervalued," then the fact that these companies' average share price subsequently went down simply provides further proof of their "undervaluation." The study's own model can explain the drop in average price from the pre-tender-offer level as simply a drop in the perceived probability of a successful takeover. *See id.* at 17. Moreover, one need not accept the assumption that all 14 of the defeated offers just happened to be the "undervalued" ones. One need only assume that the group of defeated offers contained some undervalued offers, and the net benefit or detriment of poison pills to target shareholders becomes far less clear. Of course, even "undervalued" stock, if the term is to have any meaning, must have added value that can be realized at some point. Those who maintain that the market systematically undervalues some stocks would maintain, however, that a six-month time horizon is far too short for evidence of that added value to emerge. Such revaluation, in their view, would likely result from some subsequent triggering event, like a restructuring or another takeover attempt. *See, e.g., Gilson & Kraakman, supra* note 19.

Moreover, the SEC study does not even purport to answer the question of the optimum rule to govern management's use of poison pills, but only the far narrower question of whether poison pills, *as actually utilized* between 1983 and 1986, were a net benefit or detriment to target shareholders. The study implies, however, that target shareholders in the years studied would have been better off under a rule prohibiting the use of poison pills than under the rules that courts were actually applying. *See OFFICE OF THE CHIEF ECONOMIST, SEC, supra* note 5, at 43. The study also implies that other rules, such as a rule permitting management to use pills to foster auctions, but not to remain independent, would yield results superior to those to be expected from a blanket prohibition of pills. Under the study's methodology, such a rule would have resulted in a net gain of 14%, while a straight prohibition would only have increased shareholder benefits by 2%. *Id.* at 27-28. In the end, the study provides no answer to the normative question of which rule on the use of poison pills maximizes shareholder welfare.

Another significant limitation on the usefulness of the study is that the use of poison pills, along with strategies to defeat them, may have changed significantly since the time of the SEC study. For example, three of the control contests studied ended in a "creeping" tender offer, presumably against a flip-over pill that provided no protection against such tactics. Now that pills combining flip-ins and flip-overs have become popular, one wonders whether those three acquisitions, if made today, would be made as tender offers that would lead to auctions and additional premiums, perhaps sufficiently high premiums to add three points to the average and "tip" the net balance.

114. *See supra* notes 52-54 and accompanying text.

public nature of judicial proceedings ensures that all interested parties will receive adequate notice of when an auction period will close. Also, in view of the strategic behavior common to negotiated auctions, a neutral judge, questioning from the bench, might be in a better position to ascertain the status of negotiations and parties' true positions than any of the participants. Finally, the question whether to give managers more time to negotiate or to push them toward deciding on an offer is not dissimilar to other questions that courts frequently answer; it thus seems well suited to judges' experience in sizing up and resolving concrete disputes. Once bidding has stopped, however, the market model of valuation implies that litigation over pills no longer has any useful role to play.

If uncoerced shareholder choice ought to determine a tender offer's success, then a blanket prohibition of coercive bids would seem to be the optimal rule. Even in the absence of such a general prohibition, allowing poison pills to be used against (and only against) all coercive offers might achieve the same result. Such a rule would involve little uncertainty and would be relatively easy for courts to apply.

Finding the optimal rule becomes somewhat more complicated, however, if one accepts the premise that at least some takeover bids target stock that the market undervalues. In such cases, directors might maximize values to target shareholders by using poison pills to resist such bids. One can still state, as a purely theoretical matter, that the appropriate rule should permit the use of pills against bids for "undervalued" shares, and no others. The problem, of course, is that there is no operational rule for distinguishing bids for undervalued shares from offers to pay a premium for appropriately valued shares. Nor is it possible to tell when a bid is sufficiently high that it no longer represents an attempt to profit from discounted share value, but rather offers more than the share value that incumbent management will likely realize in the long term.

Moreover, as a practical matter, who could completely make such a determination, and what criteria could they apply? By definition, the market price is not a valid measure of undervalued shares' value; nor are the shareholders' subjective valuations since their refusal to pay a price representing the true value of the shares has led to the undervaluation. That leaves only two possible arbiters of an offer's adequacy: the courts and target management. Establishing either of these as a decisionmaker clearly presents difficulties. Judges, while presumably impartial, probably cannot evaluate the adequacy of a tender offer price against a company's future prospects more effectively than shareholders or the market. Target managers, in contrast, may well have unique insights and exper-

tise into a company's future prospects, but are likely to be far from impartial.

Given these problems, those who believe in the existence of market undervaluation have three possible options in prescribing practical rules to govern tender offers. The first is to acknowledge undervaluation in theory but to ignore it as a practical matter. If the dangers of judicial mistake and management bias are so great either group's evaluations of tender offer prices are likely to yield a greater number of erroneous decisions (i.e., more adequate offers deterred and undervalued ones permitted) than would a straightforward auction or shareholder-choice rule (which, under the assumptions of this model, will inevitably permit some undervalued offers to succeed), then an auction or shareholder-choice rule is still the optimal practical rule.

The second alternative is to try to reduce the likelihood of judicial mistake by creating a legal rule¹¹⁵ that courts can apply fairly predictably and that will enable courts to distinguish adequate tender offers from inadequate ones.¹¹⁶ This approach would be optimal only if it would in fact result in fewer mistakes (as defined above) than other potential modes of enforcement would.¹¹⁷

The third alternative is to try to reduce the effects of target management's partiality by putting such managers in a situation that creates powerful incentives for accurately assessing their company's future prospects when they decide whether a pending offer is adequate. As part I demonstrates,¹¹⁸ target management defending a suit that seeks redemption of a poison pill faces potential damages that far exceed the value to management of a successful tender offer defense. In deciding whether to redeem the pill, seek a higher offer, or try to remain independent, target management thus has a strong incentive to accurately assess its company's future prospects.

A regime of legal uncertainty forces incumbent management to constantly weigh its own desire to remain in control against a downside risk of massive liability for breach of fiduciary duty. Although it cannot easily predict the results of such a lawsuit, management knows that it can substantially improve its chances of success if the value it can subsequently realize for shareholders exceeds the value of the offer it is seeking

115. See *supra* note 67.

116. Gilson and Kraakman undertake essentially that project in their recent article. Gilson & Kraakman, *supra* note 19, at 266-71 (creating "an effective proportionality test").

117. In the case of Gilson and Kraakman's proposal, the rule relies on independent directors and their advisors exercising at least a modicum of good faith as they make "plans" for realizing those hidden values, as well as some judicial ability to evaluate such plans. *Id.* at 271-73.

118. See *supra* notes 41-46 and accompanying text.

to defeat. On the other hand, if management defeats the offer and stock prices fall and remain low, both the likelihood that stockholders will bring fiduciary duty suits and the likelihood that management will lose those suits increase. Such considerations are likely to counteract management's normal enthusiasm and optimism about its own plans for enhancing the company's prospects. Unless management feels relatively certain that it can unlock sources of value that the market has not seen, it may feel a strong incentive to accept the highest offer tendered.

Uncertainty and lack of definitive judicial guidance concerning pill redemption also encourage raiders to increase their offers, even in the absence of a competitive bid. A raider has relatively little incentive to raise its offer once it has either won or lost in poison pill litigation.¹¹⁹ If, however, the raider knows that it faces an incumbent board that is uncertain about whether it can legally refuse to redeem the pill, each dollar of added value increases the pressure on that board. This possibility gives raiders an incentive to offer a higher price, even to the most self-interested and entrenchment-oriented target boards. Such an incentive also has some tendency to alleviate the problem of undervalued bids.

Accordingly, in a regime of legal uncertainty, even an utterly self-concerned management group must try to make the most accurate possible comparison between the value offered by a raider and the value that management believes it can obtain in the future. Precisely such a comparison determines whether an offer is adequate or not, and incumbent managers, who might well be in the best position to do so, make this comparison under circumstances in which their own self-interest requires extreme care.¹²⁰

For this model to work, the threat of subsequent litigation must be real but not overwhelming. Too great a fear of liability would induce management to accept inadequate offers. Too great an insulation from liability would destroy the incentive effect altogether.¹²¹ It is not neces-

119. If it has won, the pill no longer poses a threat. If it has lost, however, it may rationally believe that only a very large increase in the premium offered would induce fully protected management to give up its position of control.

120. I do not mean to imply that incumbent managers make this decision alone. Presumably, they make these determinations on the basis of advice from their lawyers about the nature and degree of potential litigation threats, and advice from their financial advisors about the value that the company can realize.

121. Some may argue that the ubiquity of directors' and officers' insurance and statutes like DEL. CODE ANN. tit. 8, § 145 (1983 & Supp. 1988) (if party acted in good faith, in manner she reasonably believed did not oppose best interests of corporation, and had no reasonable cause to believe conduct was unlawful, she can be indemnified even if convicted or judgment was entered against her), give officers and directors so much protection from personal liability in such suits that the incentive to evaluate offers carefully is weak or nonexistent. The issue, however, is not how likely directors are to be held personally liable, but how likely they are to be concerned about the

sary, however, that a great deal of such litigation occur¹²² or that case outcomes be clear and predictable. It is enough if a few polar cases establish that management has little to worry about if it subsequently realizes more value for its shareholders than a raider has offered, but that management runs a more serious risk if it does not realize such value.¹²³

CONCLUSION

This Article has considered the uncertainty surrounding poison pill litigation not as a problem to be solved, but as a phenomenon to be explained. It has attempted to show that uncertain legal standards might, under some circumstances, function well as or even better than the most clear and predictable ones. This seems particularly true in the area of poison pill litigation, where courts have proven unwilling to enunciate rules that will determine the results of takeover contests, yet hold a strong conviction that the actions of the participants require careful judicial surveillance. The Article has suggested why such a judicial attitude may be valid and justifiable, and why a regime of continuing legal uncertainty may be the most desirable means of poison pill regulation.

possibility. Modern life is filled with instances of individuals giving undue concern to certain types of dangers (e.g., muggings) that are statistically far less probable than other dangers for which they show less concern (e.g., car accidents). The outcry over *Van Gorkom* and the powerful pressures for giving managers additional protection indicate that substantial concern with these matters remains. In the poison pill area, where a raider can easily allege "willful" wrongdoing and alleged damages can easily exceed the amount of any insurance coverage, these concerns are probably even greater.

122. As Professor Cox has pointed out, a derivative suit remedy whose primary function is deterrence rather than compensation may have the desired effect at a much lower level of private enforcement activity. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 775-76 (1984).

123. Such a result is likely to follow from the very nature of the injury claimed. If shareholders who miss out on a deal because of management's failure to redeem a poison pill subsequently obtain equal or greater value for their shares, it is hard to see what damages they could receive. See, e.g., *Terrydale Liquidating Trust v. Barnes*, 642 F. Supp. 917, 928 (S.D.N.Y. 1986) (no breach of fiduciary duty when subsequent sale of assets provided more value than defeated tender offer), *aff'd*, 846 F.2d 845 (2d Cir. 1988).